THE IMPACT OF OWNERSHIP STRUCTURE, AUDIT QUALITY, AND FIRM SIZE TOWARD EARNINGS MANAGEMENT THROUGH REAL ACTIVITIES MANIPULATION

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Abstract

This research is conducted in order to prove the impact of ownership structure, audit quality, and firm size toward earnings management through real activities manipulation proxied by REM Index. Purposive sampling is used as the sampling method. Samples included in this research are manufacturing firms listed in Indonesian Stock Exchange (IDX) during 2009-2014. Based on the criteria, there are 577 manufacturing firms used as a sample. Multiple regression is used to test the hypotheses.

The result shows that institutional ownership, managerial ownership, and audit quality do not have any impact toward real earnings management. Otherwise, firm size positively and significantly impacts toward real earnings management.

Keywords: ownership structure, institutional ownership, managerial ownership, audit quality, firm size, abnormal cash flow from operations, abnormal production, abnormal discretionary expenses, real earnings management, REM Index.

I. Introduction

1.1. Background

The financial statements are one of the source of information that can be used by external parties for decision making. One of the financial statements that indicate the company's performance for a given period is income statement (Ujiyantho and Pramuka, 2007). Income numbers provided in the financial statements has the ability to affect users of the information in making decisions regarding to the company. Earnings information is part of the financial statements that are often modified through opportunistic actions of management to maximize their own benefits. Actions concerned with their own interests is done by managing the earnings so that profit can be adjusted, increased, or reduced in their own desire, such behavior is known as earnings management.

Earnings management can be done either through accrual or real activities manipulation. Accrual manipulation is done by manipulating discretionary accruals. The accrual-based earnings management is related to unreasonable change in accounting policy or accounting estimates (e.g. the useful life of assets, the residual value of assets, the amount of doubtful accounts) and change in accounting choices (e.g. depreciation method) to meet target earnings numbers (Kiattikulwatana, 2014). The amount of discretionary accruals is depending on management's decision; therefore, company's earnings can be increased or decreased by depending on managers' interest.

Commonly, nowadays managers have more tendency to apply real activities manipulation rather than accrual. There are two reasons behind this condition. First, accrual manipulation often becomes the center of observation or inspection by the auditors and the regulators. Second, focus attention only on accrual manipulation is a risky action because the company may have limited flexibility to manage accrual (Graham et al., 2005).

Institutional and managerial ownership as part of the components in the agency theory is an ownership percentage of ordinary shares held by financial institutions. Ownership by financial institutions will potentially increase the control and monitoring in the company, where managers as the owners will try to increase the quality of the

financial statements, as managers also act as the owners; therefore, it will be able to limit the real earnings management practice.

The information asymmetry associated with the separation of ownership and control between principals (owners) and agents (management) create demand for external audit (Gerayli et al., 2011). External parties such as auditors is expected to limit the practice of accrual earnings management; therefore, the presence of auditors will increase the tendency of managers to engage in real earnings management, because when companies experience accounting inflexibility, companies will use real earnings management as an alternative (Ewert and Wagenhofer, 2005) in Radityo (2013).

Firm size serves a proxy of political cost, considered to be very sensitive in case of earnings management behavior (Watts and Zimmerman, 1986). The bigger the company will also have bigger political cost where it will lead to higher tax paid and upcoming new regulations which means the managers will have more tendency to alter the earnings reported together with the bigger the size of the company.

1.2. Research Questions

1. Does institutional ownership have a negative impact toward real earnings management?
2. Does managerial ownership have a negative impact toward real earnings management?
3. Does audit quality have a positive impact toward real earnings management?
4. Does firm size have a negative impact toward real earnings management?

1.3. Research Objectives

1. The impact of institutional ownership toward earnings management through real activities manipulation.
2. The impact of managerial ownership toward earnings management through real activities manipulation.
3. The impact of audit quality toward earnings management through real activities manipulation.
4. The impact of firm size toward earnings management through real activities manipulation.

1.4. Research Contributions

This research can give a contribution in theory relating to the impact of ownership structure, audit quality, and firm size toward real earnings management practice in Indonesia. A good governance limited to institutional and managerial ownership, quality audits, and firm size may not absolutely give quality financial statements, as there is a possibility to find any real activities manipulation in financial statements, therefore investors should be cautious and have a deep fundamental analysis before investing.

II. Hypotheses Development

2.1.1. Institutional Ownership and Real Earnings Management

According to agency theory, institutional ownership in the company is one of the factors that may affect the company's performance. Institutional investors as sophisticated investors will be able to control decisions made by the management through effective monitoring process. The institutional shareholders, different than common shareholders, have ability and knowledge that do not belong to common shareholders so they can provide more active monitoring that is difficult for smaller, more-passive or less-informed investors (Almazan, Hartzell and Starks, 2005), making them possible to reduce the ability of managers to opportunistically managing earnings (Alves, 2012).

The greater ownership of financial institutions, the greater the power of financial institutions to monitor the management and eventually the management is expected to be less engaged in earnings management practice through real activities manipulation. So, the hypothesis will be formulated as:

H1 = Institutional ownership has a negative impact toward real earnings management.

2.1.2. Managerial Ownership and Real Earnings Management

Managerial ownership has the same function as institutional ownership, as it is intended to reduce the information asymmetry between shareholders and the management. The presence of managerial ownership is important in order to reduce information asymmetry, as stated by Jensen and Meckling (1976) that by increasing the

percentage of managerial ownership, the shareholders' interests can be aligned with managers' interests so it will reduce information asymmetry.

Jensen and Meckling (1976) stated that integrating interests of owners and managers may reduce the conflict of interests by giving shares to managers. If managers are owning company's shares, managers will have more motivation to increase firm's performance, where they also act as shareholders.

The higher the managerial ownership, it is expected that lesser real earnings management practice engaged by the management. So, the hypothesis will be formulated as:

H2 = Managerial ownership has a negative impact toward real earnings management.

2.1.3. Audit Quality and Real Earnings Management

Earnings management practices can be explained by the agency theory. Agency theory assumes that the agents have more information than the principals, because the principal cannot sustainably observe the agents' activities. In a such condition, it is necessary to have a third party, namely auditor that is considered capable of aligning the interests of the principals (shareholders) and the agents (management) in managing and supervising the financial statements. Ardiati (2005) mentioned that high quality auditor is able to act as an effective deterrent for earnings management. Herawaty (2008) stated that audit quality is assessed from the role of auditors that having more accurate and effective training and auditing procedures, auditor independency, and the amount of human resources in order to provide certainty related to accounting numbers reported by the management.

According to Johnson et al., 2002; Balsam et al., 2003, quality auditors may reduce accrual earnings management practice that may effect on accounting inflexibility of the clients. As the clients have such inflexibility, they have an alternative that is practicing real earnings management rather than accrual earnings management. The clients with stronger motivations to manipulate earnings will be more likely to engage in real earnings management (Radityo, 2013).

The higher the quality audit, the higher level of real earnings management. So, the hypothesis will be formulated as:

H3 = Audit quality has a positive impact toward real earnings management.

2.1.4. Firm Size and Real Earnings Management

According to political cost hypothesis, earnings management is practiced by the bigger firm because the management has a motivation to lower the number of earnings thus the political cost will decrease. Political cost hypothesis also explained that earnings management practice is caused by government's regulation, for instance, tax establishment. The bigger firms are expected to engage more in earnings management compared to smaller firms, because the political cost hypothesis assumes that firms will tend to show their profits lower by using different accounting methods and procedures so that the firm does not attract the attention of politicians, who will have an eye on high profit industries (Deegan, 2009).

The bigger the size of a firm, the higher level of real earnings management. So, the hypothesis will be formulated as:

H4 = Firm size has a positive impact toward real earnings management.

III. Research Methodology

3.1. Research Population and Sample

This research uses the population of all of the listed manufacturing firms in Indonesian Stock Exchange (IDX). Manufacturing firms are chosen because manufacturing firms tend to engage more in real earnings management more than non-manufacturing firms (Oktorina dan Hutagaol, 2008).

Purposive sampling method is used in choosing the sample, which is choosing the sample from populations based on the certain criteria (Mustakini, 2007). These criteria are:

1. The financial statement is published in the research period (2009-2014).
2. The financial statement is published in Rupiah currency.

3.2. Type and Data Collection Method

Type of data that will be used is secondary data which are financial statements of the manufacturing firm from 2009-2014 that accessed from Indonesian Stock Exchange (idx.co.id) and Indonesian Capital Market Directory (ICMD).

3.3. Operational Definition and Measurement of Research Variables

3.3.1. Independent Variables

Independent variable is a variable which is not affected by any other variable. In this research, ownership structure (institutional and managerial ownership), audit quality, and firm size serve as independent variables.

3.3.1.1. Institutional Ownership

Beiner et al., (2003) defined institutional ownership as the percentage of voting rights owned by institutions. Institutional ownership is where shares are hold by financial institutions i.e. insurance company, banking company, pension fund company, and investment banking company (Siregar and Utama, 2005).

$$\text{INST} = \frac{\text{Shares held by institutional firms}}{\text{Outstanding share capital}}$$

3.3.1.2.Managerial Ownership

According to Sujono and Soebiantoro (2007) in Sabrina (2010), managerial ownership is where shares are hold by the company's management measured by percentage of shares owned by management. The management is CEO, directors, and managers of the firm (Alves, 2012). Managerial ownership is measured by percentage of shares owned by the management from total outstanding shares.

$$\text{MGOW} = \frac{\text{Shares held by the management}}{\text{Outstanding share capital}}$$

3.3.1.3. Audit Quality

Audit quality is measured by public accounting firm or KAP of auditors which is distinguished into two categories: KAP Big-4 and KAP non-Big 4. Big accounting firm or KAP (KAP Big-4) will conduct the audit with the perceived higher quality than the small accounting firm or KAP non-Big-4. Big-4 KAP in Indonesia are:

1. KAP Purwantono, Sarwoko, and Sandjaja affiliated with Ernst and Young (E & Y);
2. KAP Haryanto Sahari & Co. affiliated with PricewaterhouseCoopers (PwC);
3. KAP Osman Bing Satrio & Co. affiliated with Deloitte Touche Thomatsu (DTT);

4. KAP Siddharta, Siddharta, and Widjaja affiliated with Klynveld Peat Marwick Goerdeler (KPMG).

Public accounting firm or KAP size is measured by nominal scale through dummy variable. Value 1 is representing the firm audited by KAP Big-4, whereas value 0 is for the firm audited by KAP non-Big 4.

3.3.1.4. Firm Size

Firm size is a value that indicates the size of the company, where it can be measured by using total assets. Assets, according to Kieso (2011), is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. Total assets are chosen as a proxy of firm size because it is relatively more stable than any other measure to assess the size of the company (Sudarmadji and Sularto, 2007).

Firm size is obtained from the natural logarithm of total assets of the company in the research period.

$$\text{SIZE} = \ln(\text{Total Assets})$$

3.3.2. Dependent Variable

In this research, earnings management through real activities manipulation will serve as the dependent variable. According to Roychowdury (2006), real earnings management is departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations. Real earnings management can be detected by using three proxies: abnormal cash flows, abnormal production costs, and abnormal discretionary expenditures. In this research, Roychowdury (2006) model are used:

$$\frac{CFO_t}{Assets_{t-1}} = \alpha_0 \left(\frac{1}{Assets_{t-1}}\right) + \alpha_1 \left(\frac{Sales_t}{Assets_{t-1}}\right) + \alpha_2 \left(\frac{\Delta Sales_t}{Assets_{t-1}}\right) + \acute{\varepsilon}_t \qquad (1)$$

$$\frac{PROD_t}{Assets_{t-1}} = \alpha_0 \left(\frac{1}{Assets_{t-1}}\right) + \alpha_1 \left(\frac{Sales_t}{Assets_{t-1}}\right) + \alpha_2 \left(\frac{\Delta Sales_t}{Assets_{t-1}}\right) + \alpha_3 \left(\frac{\Delta Sales_{t-1}}{Assets_{t-1}}\right) + \acute{\varepsilon}_t \qquad (2)$$

$$\frac{DISX_t}{Assets_{t-1}} = \alpha_0 \left(\frac{1}{Assets_{t-1}}\right) + \alpha_1 \left(\frac{Sales_{t-1}}{Assets_{t-1}}\right) + \acute{\varepsilon}_t \quad (3)$$

Description:

- CFO = cash flow from operations as reported on the statement of cash flows
- PROD = production costs, defined as the sum of cost of goods sold and change in inventory
- Assets = total assets
- Sales = total sales
- DISX = discretionary expenditures, defined as the sum of advertising expenses, R&D expenses, selling, general and administrative expenses (SG&A). Discretionary expenses are expenses occurred due to management's discretionary (Carter, 2006). Salary and tax expenses are excluded as both of them are non-discretionary.

In this research, residuals are taken as level of abnormal cash flow from operations, abnormal production costs, and abnormal discretionary expenses. For the sake of convenience and uniformity, residuals of abnormal cash flow from operations and abnormal discretionary expenses are multiplied by -1 (Tabassum et. al., 2013). The higher the residuals means the higher level of real earnings management through cash flow from operations, abnormal production costs, or abnormal discretionary expenses. According to Tabassum et al. (2013), this research uses REM Index to measure the overall of real activities manipulation.

REM Index is calculated by using the equation below:

$$\text{REM Index} = -\text{residuals AbnCFO} + \text{residuals AbnProd} - \text{residuals AbnDiscExp}$$

Description:

Residuals Abn_CFO = Abnormal cash flow from operations residual

Residuals Abn_Prod = Abnormal production residual

Residuals Abn_DiscExp = Abnormal discretionary expenses residual

3.4. Empirical Model

To test the hypotheses, this research uses the following multiple linear regression model:

$$\boldsymbol{EM = \beta 0 + \beta 1\ INST + \beta 2\ MGOW + \beta 3\ AQ + \beta 4\ FS + \varepsilon}$$

- EM = total residuals of earnings management through real activities manipulation
- INST = institutional ownership
- MGOW = managerial ownership
- AQ = public accounting firm or KAP size
- FS = firm size
- ε = an error term

3.5. Data Analysis Methods

Data analysis methods used in this research include statistics descriptive analysis, normality test, classical assumption analysis (multicollinearity, heteroscedasticity, and autocorrelation), and multiple linear regression to test the hypotheses.

IV. Descriptive Statistics Analysis and Discussion

Descriptive statistics is an analysis that describes research data. Descriptive statistic that is used in this research includes minimum value, maximum value, and standard deviation. From the descriptive statistics analysis, EM (Real Earnings Management) as the dependent variable has the minimum value of -2.0339, maximum value of 1.714, average value of -0.0742, and the standard deviation of 0.4572.

INST (Institutional Ownership) as an independent variable has the minimum value of 0.00, maximum value of 0.92, average value of 0.1422, and the standard deviation of 0.2308. MGOW (Managerial Ownership) as an independent variable has the minimum value of 0.00, maximum value of 0.33, average of 0.0101, and the standard deviation of 0.0373. AQ (Audit Quality) has the minimum value of 0, maximum value of 1, average value of 0.37, and the standard deviation of 0.482.

Normality test is conducted by using One Sample Kolmogorov-Smirnov Test. Based on normality test of 686 manufacturing firms as a sample, significance value showed $0.0000 \leq 0.05$, which means sample is not normally distributed. Therefore, trimming is conducted to eliminate outlier data to make sample normally distributed. Outlier identification is conducted, and found 109 samples need to be eliminated. After normality test is reconducted, significance value showed $0.057 \leq 0.05$, which means sample is normally distributed.

Multicollinearity test is conducted to test the correlation of independent variables in research model. Multicollinearity can be detected Multicollinearity can be detected by Variance Inflation Factor (VIF) and tolerance value (TOL) as a rule of thumb. Below is the result of multicollinearity test:

Table 4.1
Multicollinearity Test Result

Variable	Collinearity Statistics	
	Tolerance	VIF
INST	0.986	1.014
MGOW	0.962	1.039
AQ	0.753	1.328
SIZE	0.739	1.353

Based on the table above, the multicollinearity test shows that tolerance value of each independent variable is higher than 0.1 and VIF value of each independent variable is lower than 10. This result means that there is no multicollinearity in this research.

Heteroscedasticity test is conducted to test the regression model whether there is a dissimilarity of variance in residual from one observation to another observation. A good regression model should have a similarity of variance in residual (homoscedasticity) (Ghozali, 2009). Below is the result of heteroscedasticity test:

Table 4.2
Heteroscedasticity Test Result

Variable	Significance
INST	0.891
MGOW	0.153
AQ	0.524
SIZE	0.191

Based on heteroscedasticity test, the significant value of institutional ownership (INST), Managerial Ownership (MGOW), Audit Quality (AQ), and Firm Size (SIZE) is more than 0.05 (0.891 > 0.05; 0.153 > 0.05; 0.524 > 0.05; 0.191 > 0.05), which means there is no heteroscedasticity in this research.

The purpose of autocorrelation test is to test whether there is correlation between one observable residual to another residual. A good regression model possesses no autocorrelation. Autocorrelation test in this research is done by using Breusch-Godfrey Test. Below is the result of autocorrelation test:

Table 4.3
Autocorrelation Test Result
Breusch-Godfrey Serial Correlation LM Test:

F-statistic	0.753783	Probability	0.6439
Obs*R-squared	6.103997	Probability	0.6356

Based on the table above, the Breusch-Godfrey test result shows that Probability Obs*R-Squared (0.6356) is higher than 0.05. This result proves that there is no autocorrelation in this research.

The purpose of hypothesis testing is to measure the correlation between independent variable that affects the dependent variable. The results of multiple regression analysis are as follows:

Table 4.4
Research Model Regression Result

Variable	Coefficients (β)	Prob.
C	-0.843	0.000
INST	0.369	0.088
MGOW	2.071	0.271
AQ	-0.265	0.130
SIZE	0.049	0.002
F-statistic	12.295	
Prob. (F-statistic)	0,000	
Adjusted R^2	0.073	
Dependent Variable: EM		

Probability (F-statistic) value of 0.000 ≤ 0.05 shows that this research model is feasible to be conducted. Adjusted R^2 value of 7.3% shows that institutional ownership, managerial ownership, audit quality, and firm size are able to explain the variation of EM by 7.3%, where the rest (92.7%) is explainable by other variables outside the research model.

Hypothesis testing proves that institutional ownership, managerial ownership, and audit quality do not have any impact toward real earnings management, while firm size does have a positive significant impact toward real earnings management. Institutional ownership, in average, only consists of 14%, where mostly the institutional firms are not the majority owner in the sample companies. The institutional ownership cannot

limit the real earnings management practiced by manufacturing firms as they ignore the presence of the institutional investors while engaging in earnings management through real activities manipulation.

Managerial ownership does not have any impact on real earnings management as in average, only 1% shares is owned by the management, therefore managerial ownership is not able to align the interests in order to reduce the conflict of interests caused by owners and managers. Audit quality does not have any impact on real earnings management, as the presumed higher quality auditor which is Big-4 public accounting firm audited 37% from total of 577 samples, 211 companies in detail. The rest is audited by non-Big-4 public accounting firm which has audited 63% from total of 577 samples, 366 companies in detail. The status of Big-4 auditors does not necessarily give a better quality audit than non-Big-4 auditors. According to Siregar and Utama (2005), the status of Big-4 public accounting firm may not be a proper proxy for audit quality in Indonesia.

Firm size has a positive significant impact towards real earnings management, thus the H4 is accepted. This result supports the political cost hypothesis which assumes that firms will tend to show their profits lower by using different accounting methods and procedures so that the firm does not attract the attention of politicians, who will have an eye on high profit industries (Deegan, 2009).

V. Conclusion and Research Limitation and Suggestions

This research is conducted to investigate the impact of institutional ownership, managerial ownership, audit quality, and firm size towards earnings management through real activities manipulation proxied by REM Index. This research involves 577 companies listed in Indonesian Stock Exchange (IDX) for the year 2009-2014. As the research shows, institutional ownership, managerial ownership, audit quality does not give any significant impact towards earnings management through real activities manipulation. In the other hand, this research proves that firm size gives a positive significant impact towards earnings management through real activities manipulation.

The limitation of the research is that its adjusted R^2 is only 7.3% means the independent research variables is able to explain 7.3% of variation in real earnings

management variable, while the rest (92.7%) is explainable by other variables outside the research model, means that there are more variables outside the research model that can explain and affect the research model.

For the next research, non-manufacturing industries can be included to extend the result, not limited to manufacturing industries only. Related to low adjusted R^2, another proxy can also be included e.g. audit committee, audit fee, and audit industry specialization in order to extend the result.

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